



**Economic Development –
Revolving Loan Fund
Audit No. A2013-04**

Issued by the
Internal Audit Office
April 9, 2013

EXECUTIVE SUMMARY

The Internal Audit Office has concluded its audit of the City Development – Economic Development Revolving Loan Fund (RLF) which was created via an Interlocal Agreement dated May 16, 2000 between the City of El Paso and the County of El Paso. The initial funds available per the Interlocal Agreement were \$753,000.00. Based on the results of the audit, six (6) findings have been identified. All six of these findings are considered significant in nature.

Listed below is a summary of the six (6) significant findings identified in this report. Also listed is a chart documenting the results of the 5 loan files that were reviewed as part of the audit.

Loan Number	Loan Amount	Servicing Bank	Date Loan Closed	Current or Write off	Deficiencies			
					Underwriting	Loan Packet	Posting of Loan Payments	Collection Process
ED-52	\$100,000.00	United Bank	11/6/2008	Current	X	X		
ED-53	\$85,000.00	Bank of the West	7/30/2009	Current	X	X		
ED-16	\$15,000.00	JP Morgan Chase	8/16/2002	Write-off	X	X	X	X
ED-31	\$17,000.00	Bank of the West	3/31/2004	Write-off	X	X	X	X
ED-5	\$50,000.00	JP Morgan Chase	6/7/2001	Write-off	X	X	X	X

1. Program banks did not properly underwrite RLF loans. Our review of five (5) out of five (5) RLF loan files identified that the RLF Plan underwriting requirements were not met.
2. A review of a sample of five (5) RLF loan packets identified five (5) out of five (5) RLF loan packets that did not contain the required supporting documentation.
3. Payments to three (3) RLF write offs were not properly posted and allocated to the RLF Client Database maintained by Economic Development. This resulted in Loans Receivable being overstated by \$15,367.72. The misapplication also resulted in the improper write off of a loan that had been paid off.
4. The RLF balance is not properly maintained by Economic Development. The RLF balance available for new loans is understated by \$102,238.53 and is not:
 - Accurately being reported to the U.S. Department of Commerce Economic Development Administration (“EDA”),
 - Maintained at a 75% utilization of funding rate, with 25% percent idle (reserve).
 - Maintained in an interest bearing account.
5. The Revolving Loan Fund has been inappropriately intermingled with funds from the North American Development Bank Community Adjustment and Investments Program (CAIP) funds.
6. A review of the RLF write offs identified that the collection process is not adequate and not in compliance with the RLF Plan.

For a detailed explanation of each of the findings please refer to the appropriate finding contained in the body of this Audit Report.

BACKGROUND

Local government officials are confronted with increasingly limited sources of financing to meet the needs of expanding businesses and development activities. In response, many communities have created local revolving loan funds (RLFs). RLFs complement scarce private and public financing by recycling funds and leveraging private dollars.

The City of El Paso and the County of El Paso established a Joint Revolving Loan Fund (RLF) under the terms of an Interlocal Agreement dated May 16, 2000. The initial funds available per the Interlocal Agreement were \$753,000.00. The initial contribution by the City of El Paso was \$586,000.00 and \$167,000.00 by the County of El Paso for a total of \$753,000.00. The City/County Revolving Loan Fund (RLF) targets small businesses that can best help the City/County achieve long term economic development objectives. Preference is given to City/County projects with the greatest impact on El Paso and those that locate in the Federal Empowerment Zone, State Enterprise Zone or Renewal Community. The RLF utilizes funds available from the U.S. Department of Commerce (DOC) Economic Development Administration (EDA), and the U.S. Department of Housing and Urban Development. The City Development – Economic Development Division has been tasked with the administration of the RLF program and facilitation of the appointment of the RLF Board. The RLF Board in turn governs the RLF program. As of the semiannual report dated 9/30/2012, the RLF has issued a total of 53 loans totaling \$1,687,210. The semiannual report dated 9/30/2012 listed 9 loans as active, 21 loans as inactive/paid off, and 23 loans as written off. As of 4/9/2013, the RLF still has 5 active loans.

AUDIT OBJECTIVES

The audit objectives for the Economic Development RLF Audit were to:

1. Determine whether the RLF is administered to ensure that funds reach citizens and program objectives are met.
2. Determine whether the RLF is self-sustaining.
3. Determine whether program banks are properly underwriting and tracking loans.
4. Determine whether the RLF Loan Board is provided with accurate, timely, and complete information necessary to account for and manage the program.
5. Verify that the loan files contain adequate documentation to show evidence that the files comply with the Criteria and Guidelines contained in the City of El Paso Revolving Loan Fund Plan.
6. Verify that the collection process is adequate and in compliance with the City of El Paso Revolving Loan Fund Plan,
7. Verify that Economic Development is managing the RLF in compliance with applicable laws, regulations, and agency policies.

AUDIT SCOPE

The audit period covered the operations of the Revolving Loan Fund Portfolio established in May 16, 2000 to present.

AUDIT METHODOLOGY

In order to achieve our audit objectives we:

- Conducted interviews with City Development Department's Economic Development Division management and staff,
- Conducted interviews with Financial Services Department staff,
- Conducted a review of the administrative functions performed by Economic Development,
- Conducted an analysis of RLF portfolio based on the RLF Plan,
- Conducted a statistical analysis of loans that have been written off to identify trends that may be the underlying factors of non-performance,
- Selected a 10% sample of the 53 EDA-funded RLF Loans. A total of five (5) loans were selected for review: 2 active loans and 3 loans that have been written off.
- Conducted a review of RLF loan packets,
- Verified that Economic Development is managing the RLF in compliance with applicable laws, regulations, and agency policies.

We conducted this performance audit in accordance with Generally Accepted Government Auditing Standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

This audit was also conducted in conformance with the International Standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors.

***SIGNIFICANT FINDINGS, RECOMMENDATIONS,
AND MANAGEMENT'S RESPONSES***

The definition of a "Significant Finding" is one that has a material effect on the City of El Paso's financial statements, identifies an internal control breakdown, a violation of a City procedure, or a violation of a law and/or regulation, which the City is required to follow. Any finding not meeting these criteria will be classified as a "Regular Finding".

Finding: 1

Underwriting

Revolving Loan Fund Plan Part One. The Revolving Loan Fund Strategy:

- Section B. The Business Development Strategy,
 - 2. Targeted Loan Recipients states, *"Companies requesting the use of this financing vehicle must be in good financial condition as well as exhibit the ability to repay the loan dollars."*
 - 3. Economic Development Objectives states, *"The Revolving Loan fund will promote economic development and revitalization through implementation of the following objectives: ...e. Enhance the formation and expansion of minority and women-owned business or HUB's."*
- Section D. Financing Policies,
 - 2. Terms, RLF Funding Formula states, *"The Revolving Loan Fund program requires the borrower to provide 10 percent of the equity, assets or cash investment in terms of financing the entire project."*
 - 3. Security states, *"Personal guarantees are required from shareholders with 20 percent or more ownership in the applicant company."*

Revolving Loan Fund Plan Part Two. Revolving Loan Fund Operational Procedures:

- Section B. Loan Processing Procedures, 1. Standard Loan Application Requirements provides a listing of documentation that loan applicants must submit in order for the loan review and approval process to begin.
- Section C. Loan Closing and Disbursement Procedures, 2. Loan Closing Documentation Requirements states, *"For all loans made by the RLF, the following documentation will be required prior to the loan closing: ...Current appraisal(s) or other acceptable documentation of value of any real property real or personal property used as collateral...Current Uniform Commercial Code (UCC) filing on any personal property used as collateral."*

Based on our review, there were deficiencies noted in the underwriting of RLF loans. A 10 % sample was selected of the 53 EDA-funded RLF Loans. A total of five (5) loans were selected for review: 2 active loans and 3 loans that have been written off. The following deficiencies were noted:

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Deficiency	Description	# of Loan Files	Loan Numbers
1.	No indication of UCC filings being conducted prior to loan closing.	5	ED-5, ED-16, ED-31, ED-52, ED-53
2.	No indication of appraisal on the real property, machinery, or equipment that was used as collateral.	4	ED-16, ED-31, ED-52, ED-53
3.	Loan recipients did not provide 10% of the equity, assets, or cash investment in financing the entire project.	3	ED-16, ED-52, ED-53
4.	Loan recipients did not demonstrate good financial condition and the ability to repay the loan dollars.	2	ED-31, ED-53
5.	Loan recipients did not provide personal guarantees of 20% or more.	2	ED-5, ED-16
6.	No loan documents were located in file so the financial condition of the loan recipient could not be determined.	1	ED-53
7.	No indication that the loan enhanced the formation and expansion of minority, women-owned business or HUBs.	1	ED-31

Recommendation:

Economic Development Division should ensure that RLF loans are properly underwritten and loan packets are documented in accordance with the RLF Plan documentation requirements.

Management's Response:

Economic Development Staff is in the process of seeking a substitute grantee for the City/County Revolving Loan Fund. By acquiring a substitute grantee, the City of El Paso and the County of El Paso will no longer be responsible for reporting to the Economic Development Administration. Accion Texas has expressed an interest in becoming the substitute grantee for the City/County RLF program. Accion Texas provides loan opportunities for small businesses and entrepreneurs who do not have access to traditional loans.

In the interim, in order to prevent further discrepancies the Economic Development Division will develop a standard operating procedure, which will include a checklist of needed items on all future loan applications. The checklist shall be consistent with requirements in the Revolving Loan Fund Plan. Given that there are five active loans in the RLF portfolio no action will be taken on past accounts.

Responsible Party:

Marty Howell, Director of Economic Development and Sustainability

Implementation Date:

January 31, 2014

Finding: 2

RLF Loan Packets

Revolving Loan Fund Plan Part Two. Revolving Loan Fund Operational Procedures:

- Section C. Loan Closing and Disbursement Procedures, 3. Loan Disbursement Requirements states, “Depending on the type of loan requested, the borrower must provide proof that the loan processed will be used for the intended purposes prior to disbursement.”
- Section D. Loan Servicing Procedures, 2. Loan Monitoring Procedures states, “Each RLF borrowing company will be required to submit an unaudited quarterly financial statement, prepared by a Certified Public Accountant...companies may be required to submit proof of purchase of property insurance.”

Based on our review, there are inconsistencies in documents maintained in the RLF Loan Files. A 10 % sample was selected of the 53 EDA-funded RLF Loans. A total of five (5) loans were selected for review: 2 active loans and 3 loans that have been written off. The deficiencies identified are as follows:

Deficiency	Description	# of Loan Files	Loan Numbers
1.	Borrower did not provide proof that loan proceeds were going to be used for the intended purposes prior to disbursement.	5	ED-5, ED-16, ED-31, ED-52, ED-53
2.	Borrowers have not been submitting an unaudited quarterly financial statement prepared by a Certified Public Accountant.	5	ED-5, ED-16, ED-31, ED-52, ED-53
3.	Borrowers did not provide proof of property insurance.	3	ED-16, ED-31, ED-52

Recommendation:

Economic Development Division should ensure that RLF loan packets are documented in accordance with the RLF Plan documentation requirements.

Management's Response:

Staff that is currently employed with the Economic Development Division did not participate in any of the underwriting procedures or servicing of loans in the current RLF portfolio. However, Economic Development Staff will develop loan procedures that include a checklist to ensure the loan process is consistent with the RLF Plan on all future loans.

Staff will also request that City Council amend the RLF Plan by removing the requirement for quarterly financial statements. Requiring quarterly financial statements is costly and difficult for small businesses that require gap financing.

Economic Development Staff will send out a letter on a yearly basis requesting proof of property insurance. Furthermore, prior to approving any loan, property insurance will be part of the checklist of items necessary for a complete loan application.

Responsible Party:

Marty Howell, Director of Economic Development and Sustainability

Implementation Date:

January 30, 2014

Finding: 3

RLF Loan Servicing

Revolving Loan Fund Plan Part Two: Revolving Loan Fund Operational Procedures, Section D. Loan Servicing Procedures states:

"The City's EDD or designated Program Administrator will be responsible for the continuous monitoring of each RLF loan in all stages of the loan process: application, approval, post loan disbursement and the entire repayment period...each loan will have its own portfolio of timely information."

A reconciliation conducted by the Financial Services Department of the RLF portfolio identified that payments to three RLF write offs were not properly posted and allocated to the RLF Client Database maintained by the Economic Development Division. This resulted in Loans Receivable being overstated by \$15,367.72. The misapplication also resulted in the improper write off of a loan that had already been paid off.

RLF Loan Number	Economic Development RLF Balance as of 8/31/2011	Balance per Financial Services Reconciliation	Adjustment made to Loans Receivable by Financial Services
ED-16	\$ 6,134.59	\$ 3,372.94	\$ (2,761.65)
ED-31	\$ 5,220.36	\$ 5,336.23	\$ 115.87
ED-5	\$ 12,721.94	\$ -	\$ (12,721.94)
Totals:	\$ 24,076.89	\$ 8,709.17	\$ (15,367.72)

Recommendation:

Economic Development Division should:

- Adjust its current balances to reflect the reconciliation conducted by the City of El Paso's Financial Services Department.
- No longer report ED-5 as a "Write-off" but instead as "Paid Off."

Management's Response:

Staff will work with the City's Financial Services Department and the Economic Development Administration to adjust balances on subject loans listed in the Revolving Loan Portfolio. In order to ensure the proper posting of future payments, the Economic Development Department will begin reconciling Economic Development Administration documents with the payments submitted to the Financial Services Department on a semiannual basis. Furthermore, the second semi-annual report due on October 31, 2013 to the Economic Development Administration will be updated to reflect corrections to the discrepancies reported by this audit.

Responsible Party:

Marty Howell, Director of Economic Development and Sustainability

Implementation Date:

December 31, 2013

Finding: 4

RLF Available Balance

Revolving Loan Fund Plan Part Two: Revolving Loan Fund Operational Procedures, Section E. Administrative Procedures states:

"The RLF program will strive to exceed more than a 75 percent utilization of funding rate, meaning that we will strive to keep less than 25 percent idle. All idle RLF dollars will continue to gain interest in an interest bearing City of El Paso account (RLF)."

The RLF Loan balance is not properly maintained and reported by the Economic Development Division. Economic Development is understating the RLF available balance by \$102,238.53.

- In the "Semiannual Report for EDA-Funded RLF Grants" for the period ending 9/30/2012, Economic Development reported an available (idle) RLF balance percentage of 70.77% with a balance of \$453,708.41.
- For the same period, the RLF Wells Fargo bank balances totaled \$555,946.94. The balance consisted of:
 - \$447,761.11 that is maintained in a non-interest bearing account.
 - \$108,185.83 that is being maintained in a Money Market Mutual Fund that earns 0.01% annually. The Economic Development Division was unaware of this separate account containing RLF funds.

Recommendation:

Economic Development Division should properly report the RLF balance and maintain idle RLF dollars at the required utilization level and in an interest bearing account.

Management's Response:

Staff is working to acquire a substitute grantee for the RLF Program. The process for acquiring a substitute grantee is contingent on three actions taking place. First, El Paso's City Council must approve and submit a letter of intent to the Economic Development Administration. Second, the substitute grantee must also submit a similar letter of intent to the Economic Development Administration. Finally, the Economic Development Administration will review the two letters of intent and approve or disapprove the request. This process is estimated to take between six to eight months. In the interim, Economic Development Staff will not make loans in order to minimize the number of loans on the RLF's loan portfolio; this will facilitate the transfer of the RLF program to a substitute grantee.

Given that existing staff has limited historical knowledge of the City/County Revolving loan fund program; Economic Development Staff will make it standard operating procedure to closely work with Financial Services to reconcile balances every six months before semiannual reports are submitted to the Economic Development Administration.

Responsible Party:

Marty Howell, Director of Economic Development and Sustainability

Implementation Date:

January 31, 2014

Finding: 5

Intermingling of RLF Funds

Revolving Loan Fund Plan Part Two: Revolving Loan Fund Operational Procedures, Section E. Administrative Procedures states:

“The joint Revolving Loan Fund will be comprised of one account with contributions made by the City in the starting amount of \$586,000 (77.82%) and the County in the amount of \$167,000 (22.18%).”

During the period of June 2004 to April 2010 transactions for the North American Development Bank Community Adjustment and Investments Program (CAIP) Fund and RLF Program were intermingled. Reconciliations conducted by the Financial Services Department identified the misapplication of transactions between the two accounts. Credit memos were issued to rectify the incorrect postings to both the CAIP Fund and the RLF accounts.

Activity		Amount Adjusted to RLF Account
CAIP transactions posted to RLF:	\$ 232,978.14	\$ (232,978.14)
RLF transactions posted to CAIP:	\$ 154,239.21	\$ 154,239.21
Total:	\$ 387,217.35	Net: \$ (78,738.93)

Recommendation:

Economic Development Division, in conjunction with Financial Services, should ensure the RLF bank account accurately reflects RLF transactions.

Management's Response:

Economic Development Staff will reconcile balances with Financial Services on a semiannual basis (March & September) to ensure proper reporting to the Economic Development Administration.

Responsible Party:

Marty Howell, Director of Economic Development and Sustainability

Implementation Date:

January 31, 2014

Finding: 6

Review of RLF Write offs

Revolving Loan Fund Plan Part Two: Revolving Loan Fund Operational Procedures,

- Section D. Loan Servicing Procedures,
 - 2. Loan Monitoring Procedures states, *“Borrower site visits will take place on an annual basis to insure that the company is visually in operation and to verify that collateralized machinery and equipment remains on the premises in good working condition.”*
 - 3. Late Payment Follow-Up Procedures state, *“Late payment that exceeds 30 days warrants a site visit by the Bank in order to discuss repayment...The Bank will notify the City’s EDD or designated Program Administrator of all late and/or default loans and their status on a monthly basis.”*
- Section E. Administrative Procedures,
 - 2. Procedures for Complying with Economic Development Administration and Texas Department of Housing and Community Affairs Reporting Requirements states, *“It is also the responsibility of the City’s EDD or Program Administrator to monitor the level of funds available for lending and to allocate the appropriate dollars to the administration account of the RLF.”*

A sample of three (3) RLF write offs was conducted in order to conduct a detailed review of the RLF collection process. The following results were obtained from all three of the loans reviewed:

- Revenues derived from the application and closing fees charged to loan recipients are not properly tracked and used for the administrations of the RLF Program.
- Borrower site visits are not being conducted on an annual basis.
- Site visits by participating Banks are not conducted when late payments exceed 30 days.
- Participant Banks do not notify Economic Development or the designated Program Administrator of late and/or default loans and their status on a monthly basis.

An analysis of the 23 RLF loans that have been written off as of September 30, 2012, identified the following statistics which may provide an indication as of the underlying factors for the non-performance of the RLF write-offs:

- 78.13% of the write-offs were granted to service businesses.
- 79% of the write-offs were granted for startup purposes.
- 53.42% of write-offs were granted for working capital.
- 64% of write-offs were underwritten by J.P. Morgan Chase Bank.
- 43.48% of write-offs were issued in the amounts between \$10,001 and \$20,000.
- 69% of the write-offs were written off in 2008.

Recommendation:

Economic Development Division should ensure the remaining active RLF loans are properly monitored and serviced in accordance with the RLF Plan.

Management's Response:

Economic Development Staff will begin conducting site visits on the five remaining loans that are outstanding and for any future loans that are provided under the City/County RLF program. The site visits will all be scheduled in October, which coincides with the second reporting period for the Economic Development Administration.

When borrowers do not submit payments as required in the loan agreement, Economic Development staff will mail out notification letters to the program lenders reminding them of their responsibilities with respect to the program lender agreement.

Responsible Party:

Marty Howell, Director of Economic Development and Sustainability

Implementation Date:

January 31, 2014

INHERENT LIMITATIONS

Because of the inherent limitations of internal controls, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control structure to future periods are subject to the risk that procedures may become inadequate due to changes in conditions, or that the degree of compliance with the procedures may deteriorate.

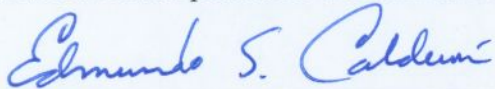
CONCLUSION

We have concluded work on the audit objectives of the Economic Development RLF Audit. In accordance with *Generally Accepted Government Auditing Standards* we are required to conclude on whether Economic Development met the objectives of this audit. Based on our audit work, we have determined the following:

1. Procedures utilized by Economic Development operated as intended by the Revolving Loan Fund Plan in the following areas:
 - The RLF has been administered to ensure funds reach citizens and target the creation and retention of new employment opportunities for El Paso workers.
2. The City of El Paso's Economic Development Division is not meeting the Criteria and Guidelines established in City of El Paso Revolving Loan Fund Plan in the following areas:
 - The RLF is not self-sustaining. 23 out of 53 (43%) RLF loans are write offs and RLF funds have not been appropriately allocated to the administration of the RLF.
 - Program banks did not properly underwrite and track loans.
 - The RLF Loan Board is not provided with accurate, timely, and complete information necessary to account for and manage the program.
 - The loan files do not contain adequate documentation.
 - The collection process is not adequate and not in compliance with the RLF Plan.
 - The RLF balance is not being properly maintained and reported by Economic Development.

Based on our review, the City of El Paso's Economic Development Division does not have expertise on staff to successfully run and monitor an effective RLF Program. The City of El Paso's Economic Development Division should consider phasing out the RLF Program.

We wish to thank the Director of the City of El Paso's Economic Development Division and Financial Services Development for his assistance in the completion of this audit.



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